



OXFORD ANALYTICA

RUSSIA

FISCAL TRANSPARENCY

Country Report 2005

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5 Alfred Street, Oxford OX1 4EH

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RUSSIAN FEDERATION



COMPLIANCE RATINGS

<i>Fiscal transparency</i>	2005	2004	2003	2002
Clarity of roles
Availability of information
Budget preparation
Accountability
Score	3.00	3.00	2.75	2.00

OUTLOOK & COMMENTARY

The Russian Federation has continued its gradual progress towards improved fiscal transparency standards, even if the general sense of urgency propelling reforms has diminished in the face of the strong economic performance of the country. The government appears committed to pushing ahead with its efforts to introduce performance budgeting in a growing number of areas. In addition, there will likely be renewed efforts to reshape the civil service structure, although the process seems to have slowed down.

The ambitious overhaul of the federal structure -- along with the formalisation of the division of responsibilities between different levels of government -- has proven more challenging than expected. Full implementation has been delayed from 2006 to 2009 and effort will have to be redoubled to build local capacity to fully assume the new responsibilities. Efforts to eliminate inefficiencies in the provision of basic services have improved through the monetisation of social benefits and the near-convergence of gas prices with international levels. However, efforts to reform the electricity and gas sectors look set to proceed relatively slowly. Privatisation will continue but subject to the constraint of keeping strategic assets in state hands.

EXECUTIVE SUMMARY

3.00 Enacted

The Russian government has continued to build on its steady progress towards improving fiscal transparency standards. The provision of information on fiscal operations has improved dramatically in recent years. The Ministry of Finance (MoF) runs a very comprehensive website, as do the Federal Treasury and the federal services responsible for taxation, customs, and other areas. The state budget bill and law have become extensive documents whose numerous appendices are now almost invariably published even before the parliamentary proceedings begin. In addition to its budget, the MoF now also publishes an indicative three-year fiscal plan, which builds on the previous three-year social strategy prepared by the Ministry of Economic Development and Trade (MEDT).

Fiscal projections remain extremely cautious and the country is increasingly prepared for the tasks of minimising fiscal risks and ensuring long-term sustainability. A key element of the government's strategy is a Stabilisation Fund that is replenished from oil revenues. However, political pressure for increasing spending from the oil and gas windfall is growing. As a result, the cut-off oil price for transfers to the Stabilisation Fund has revised upwards, although the differential will be diverted to a new Investment Fund. The purpose of the Investment Fund will be to finance important infrastructure projects.

Russian statistical data on fiscal operations is generally recognised to be of a high standard. The Federal Treasury publishes comprehensive, timely, and fairly accurate data on the operations of the entire general government and the level of detail has improved significantly in recent years. Russia's subscription to the Special Data Dissemination Standard (SDDS) of the International Monetary Fund on 31 January 2005 constituted an important recognition of the considerable progress made in converging with international best practice. The Russia metadata is recognised as being of high quality even internationally.

In spite of the generally positive progress, developments during the past year have revealed the limited capacity of the Russian administrative apparatus to meet the ambitions of policy-makers in certain areas and a number of reforms have had to be delayed. In particular, due to a lack of preparedness at the sub-national level, the overhaul of the federal fiscal relations has had to be delayed from 2006 to 2009. Similarly, attempts to introduce performance budgeting in 2005 proved largely fruitless, although the authorities remain committed to the overall goal and appear determined to learn from their mistakes. In general, progress in many areas is hampered by the limited headway made in reforming public sector administration. Indications of increasing corruption reflect the difficulties of serious reform, while the country's good economic performance appears to have reduced the sense of urgency for resolute action.

Russia's overall score is unchanged from last year.

1. CLARITY OF ROLES, RESPONSIBILITIES, AND OBJECTIVES



Enacted

The government sector should be distinguished from the rest of the public sector and from the rest of the economy, and policy and management roles within the public sector should be clear and publicly disclosed.

Structure, functions, and responsibilities of government

The Russian constitution recognises three separate tiers of government: the federal government, the 89 regions consisting of the Oblasts and Republics, and over 11,000 self-governing localities. A gradual process of mergers of the regions has begun with the objective of combining smaller regions, typically ones heavily dependent on federal subsidies with larger ones. The government also intends to introduce one more level of districts (*rayon*) above the lowest level of settlements (*poselenie*), each with distinct responsibilities.

The customary use of the concept of state bodies in legislation and administration does not yet constitute a formal definition of the general government. Further confusion is caused by entrepreneurial activities conducted by budgetary entities, the scale of which currently amounts to approximately 2.5% of GDP. The Russian Treasury has identified over 31,000 own-resource accounts connected with budgetary organisations, mostly in education, health, railways, agriculture, defence, and natural resources. Up to 70 of them, mainly in defence, remain outside of the confines of the Treasury system. None of the liabilities of any of these accounts are reported or monitored. In addition, as of 1 June 2004, Russia had 9,222 federal state-owned unitary enterprises (FGUP) whose numbers are still growing. Some of them provide quasi-fiscal services and therefore ought to be incorporated in the general government. Their accounting and reporting practices are not publicly available. However, their economic significance and revenue-generating potential are relatively marginal. Similarly, extra-budgetary activities funded by commercial operations of sub-national budgetary organisations are typically not recorded in the budgets of sub-national governments.¹

The government's "Programme for the Development of Fiscal Federalism in Russia for the Period Until 2005," approved in 2001, marked the beginning of an ambitious reform of the division of responsibilities between different levels of government. In pursuance of its objectives, the Federal Law "On Basic Principles of Organisation and Legislative (Representative) and Executive Public Authorities of the Subject Entities of the Russian Federation" was amended and a new law "On Local Self-Administration" was passed in 2003.² Recent tendencies towards greater centralisation, most notably the direct appointment of regional governors, have raised some questions about the final results of these reforms and further modification of the programme cannot be ruled out. Moreover, capacity limitations and a widespread lack of preparation on the sub-national level have led to a delay in the full implementation of this programme from 2006 to 2009.

Coordination and management of budgetary activities

The Budget Code sets out budget preparation, execution, and reporting functions. The majority of these responsibilities lie with the MoF. Within the ministry, budget preparation and budget execution roles are separated, with the Federal Treasury, which now operates as a separate federal service under auspices of the MoF, responsible for the latter.³

The federal extra-budgetary funds have been integrated in the Federal Treasury system. The Pension Fund, the Social Insurance Fund, and the system of Compulsory Medical Insurance Funds (federal and regional) are now fed from the unified social tax set up in 2001.⁴ A special expenditure optimising commission, chaired by the minister of finance, was set up in 2003 with the brief to increase the efficiency of budget expenditures, among other things by means of reducing the number of budgetary organisations. The purpose of the commission is to develop action plans across the central state administration with a view to reducing the size of the state apparatus so as to free up resources for cuts in the total tax burden of 1% a year.⁵

The law “On State Secrets” still limits the information available on the Ministry of Defence. However, the Budget Code now applies to all federal ministries and since 2001, the responsibility for the execution of the MoD budget has been transferred to the Federal Treasury. Overall, the number of classified items in the federal budget has been steadily declining and their importance is now fairly marginal.⁶ The General Office handles the fiscal activities of the Presidential Administration, and information about them is limited. Although transfers from the federal budget are presented as a separate line item in the budget law, the Presidential Administration also has other revenue sources, on which information is very limited. However, audits are conducted and published by the Accounts Chamber of the Russian Federation.⁷

The Russian system of intergovernmental relations has been hampered by a discrepancy between a high degree of decentralisation of resources and an exceptionally high degree of centralisation of fiscal authority. A permanent working group on the reform of inter-budgetary relations in the country has operated at the MoF since 1999 and considerable progress has been made towards establishing a system of fiscal federalism.⁸ Since 2000, transfers to the regions have been determined using a refined methodology based on objective indicators and an assessment of fiscal capacity. Capital transfers also consider inter-regional equalisation objectives. Some special transfers are made conditional on undertaking particular kinds of reforms. The main problem is that inter-budgetary loans continue to be extended and rolled over in violation of the Budget Code. In spite of attempts to impose discipline and reform the system, soft loans have tended to reappear in different guises; for example, the Fund for Improving Budget Balance.⁹ While transfers to the regions are recorded in the budget, there is no regional breakdown of direct federal spending. It is thus difficult to determine the overall scale of general government spending in any one region.

A clear delineation of tasks between the different levels of government has not been achieved yet. Non-funded federal mandates for the regions have diminished in number, although the problem has not been completely eliminated. In particular, the monetisation of social benefits in 2005 was a major step forward. Starting in 2004, sub-national governments have enjoyed a great deal more autonomy in implementing their expenditure responsibilities. Under Article 134 of the Budget Code, subjects of the Federation receiving federal transfers are required to keep their accounts at the Federal Treasury.¹⁰ Further structural reform is likely to be required before a fully functioning system of fiscal federalism can be established. In particular, communal services and housing are still managed in a very inefficient and opaque fashion, although the monetisation of social benefits has significantly improved the situation.¹¹

In observance of the “Programme for the Development of Fiscal Federalism,” inter-regional fiscal relations are being further refined. The ongoing reform efforts are in part designed to reduce tax sharing in favour of a system under which revenues from individual taxes are completely attributed to particular levels of government. For example, personal income tax receipts are equally split between regions and municipalities. Considerable progress has been made in this area, although some taxes, such as profit tax, remain split between the federal and the sub-national level. The federation now keeps 60% of VAT receipts. In spite of the greater clarity in allocating tax revenues streams, there are very few local taxes in a system that relies virtually entirely on redistributing taxes collected by the Federal Treasury. Local authorities have limited flexibility in setting the rates of local taxes and they cannot introduce taxes not included on a federally approved register. The number and level of local taxes has no bearing on transfers from the centre. Sub-national governments are free to set up their own off-budget funds and statistical information about them is very scarce.¹²

Many regions are dependent, in some cases heavily, on federal subsidies. In 2001, 22 regions received more than one-half of their budgets from Moscow. Particular restrictions apply to the autonomy of such recipient regions. Among other things, they are not allowed to pay their salaries in excess of the federal scales, a possibility now available to donor regions. The government is currently seeking to consolidate the regional structure in order to reduce the number of economically unviable regions.¹³

Starting in 2004, concerted efforts have been made to transpose the system of federal-regional transfers to the relationship between regions and municipalities. Historically, the procedures have been characterised by a great deal of discretion in most regions. The process is expected to become increasingly formalised in legislation.¹⁴

The earlier plans for federal reform have been modified by transferring the responsibility of appointing regional governors to the president of the federation. Previously, the governors were elected by a popular vote. Even as the ultimate direction of federal reform remains unclear, there is a broad-based consensus on de-politicising inter-budgetary relations and on establishing a closer correspondence between the responsibilities of individual authorities and their economic base.¹⁵ However, it is increasingly obvious that the process will prove slower than was initially expected. For example, plans to transfer new responsibilities to the municipalities in 2006 have had to be postponed by two years because many municipalities lack the administrative capacity to take on the tasks. The limitations of the local institutions became particularly obvious in connection with efforts to implement the new social benefits legislation in January 2005. Partly as a result, many other reforms have been slowed down, since there is a greater awareness of the need to verify institutional preparedness for new policies.

Relations between government and public sector agencies

The Central Bank of the Russian Federation (CBR) is defined by law as an independent institution and cannot provide any financial assistance to the government, unless called to do so by the federal budget law. Nor can it purchase government securities on the primary market. Three of the 12 members of the National Banking Council come from the federal government. In addition, the minister of finance and the minister of economic development and trade can attend meetings of the CBR's decision-making board as non-voting members. While the CBR provides banking services to the government, it does not charge any fees for them. In return, it does not pay interest on any government deposits.¹⁶

The most important natural monopolies in the energy sector remain to a significant degree government-owned. In spite of considerable restructuring, quasi-fiscal activities take place on a substantial scale. A strategy for fully eliminating cross-subsidies to households by large industrial users over the next three years is currently under preparation by the Federal Tariff Service (*Federalnaya sluzhba po tarifam*). As an intermediate measure, the process of setting tariffs has been made a great deal more transparent. Although gas prices have increased close to recovery levels, electricity tariffs remain subject to heavy regulation. The lack of effective competition in the sector is a source of efficiency losses. Plans to restructure RAO United Energy Systems have been delayed following the launch of a competitive segment covering 15% of the electricity sector in 2003. The competitive segment has operated with considerable success, but a full liberalisation of the wholesale market is seen as unlikely before 2008-10. The urgency of comprehensive restructuring has significantly diminished due to the dramatically improved fiscal situation of the government in recent years, concessions made by especially the EU in the WTO accession talks, and concerns over the social implications of reform. Nonetheless, gradual progress is being made in restructuring the generation sector.¹⁷ The sector is set to consist of seven wholesale companies and 14 regional power generators, which will operate in competitive conditions. In contrast, an estimated seven distribution companies controlling the grid will remain in state hands and will not be subjected to competition.

Gazprom is currently undergoing a process of rapid expansion reflective of the government's strategy to turn it into a national champion of the strategically important hydrocarbons sector. The state has regained majority control of the

company, even if the plan to merge with Rosneft to create a national champion was abandoned. Comprehensive de-regulation of the gas sector is not likely in the near term. Nor is it as urgently needed as in the electricity sector, since gas prices have over time been brought quite close to market levels. The main challenge remains ensuring other gas producers equal access to the distribution network which Gazprom controls.

Overall, the economic costs of delayed de-regulation in the utilities sector are considerable. The IMF in 2004 put the total cost of the cross-subsidies at up to 135 billion roubles for Gazprom and as much as 345 billion roubles for UES.¹⁸ Eliminating them is likely to be a gradual process in a country where income differentials remain enormous and the climate makes heating a highly politically sensitive issue. For example, a full liberalisation of energy prices might double or even triple the rates faced by private consumers. The electoral cycle is likely to play an important role in the timing of reform. Moreover, creating a mechanism to control price volatility would seem a necessary condition for significant liberalisation at least in the short run.

Government involvement in the private sector

Even though the Russian economy has been profoundly transformed as a result of an ambitious privatisation programme over the past decade, a great deal of property remains at least partially in government hands. As of 1 June 2005, the federal government owned stakes in a total of 3,783 joint-stock companies. In addition, it controlled 8,293 unitary SOEs. Government presence is especially strong in hydrocarbons, machine building, agriculture, transport, construction, and services.¹⁹ Moreover, the trend towards steady divestment has been partially reversed since last year. The government has made an open commitment to ensuring sufficient control of the so-called strategic sectors. Among other things, the government has acquired majority control of the gas giant Gazprom and expanded the state oil producer Rosneft through acquisitions in the private sector, including the controversial break-up of Yukos.

The government recognises the critical, and growing, importance of the energy sector for the conduct of Russia's foreign policy and is thus eager to ensure adequate influence over the sector. The exploitation of a number of key sub-soil assets will be open exclusively to majority Russian-owned companies. In addition, the government is committed to maintaining a strong presence in the financial sector and there are no plans to privatise the leading state-controlled banks Sberbank, Vneshtorgbank, and Vneshekonombank. In other areas, however, the government is continuing with its privatisation programme, which is approved simultaneously with the annual budget. The government's privatisation programme for 2006-08 is marked by a continued commitment to reducing the number of SOEs not necessary for the effective fulfilment of government function as well as to cutting the numbers of unitary SOEs.²⁰ Comprehensive legislation exists to properly regulate the process of privatisation.²¹

The efforts to ensure proper government control of strategic assets and sectors of the economy appear to be accompanied by a commitment to formalising the relationship between the government and the rest of the economy. Even the process of redrawing the line between the public and the private sectors has become much more transparent and predictable. For example, the purchase of Sibneft by the state-owned Rosneft took place at the market price. Moreover, gradual improvement can be expected in the governance standards of SOEs, with an impending removal of limitations on the foreign ownership of Gazprom and the initial public offering of Rosneft two important steps in this direction.

Even though corporate governance standards are improving, elements of government involvement in the private sector remain opaque. Examples include irregularities with the sale of government assets and support to companies through tax-offset mechanisms. Although direct subsidies to companies have become relatively rare, regulated energy prices constitute a major indirect subsidy. In addition, the Yukos affair has raised questions about arbitrary government interference in the private sector. The main source of concern has had to do with back tax claims on companies and only partially successful attempts to properly formalise and limit them. In spite of government

efforts to allay investor concerns, tax claims have frequently been resolved through bargaining where the end result has borne little relation to the initial claim.

The government still regulates the private sector in ways that can be counter-productive and burdensome. However, steady, albeit not entirely continuous, progress is being made to professionalize the system. In addition, there has been fairly significant de-regulation with respect to small and medium-sized companies with a pronounced positive impact on their situation.²² Policy implementation continues to be compromised by the low compensation and a lack of professionalism of large segments of the state bureaucracy, which is a common source of delays, additional costs, and inefficiency.²³ Enforcement is problematic owing to a largely incompetent judiciary, although some progress has been made in judicial reform.²⁴ In spite of positive progress, particular problems continue to persist with respect to the protection of minority shareholder rights, business reorganisation, bankruptcy, and takeovers.²⁵

In the face of persistent and even growing inflationary pressures, the government has been using increasingly unrealistic inflation projections in drafting its budget. While partly connected with controlling inflation expectation and a desire not to undermine the credibility of the inflation targets agreed with the CBR, the situation has resulted in an inflation tax. There is no mechanism for an automatic inflation adjustment of the tax brackets.

There should be a clear legal and administrative framework for fiscal management

Legal framework for budgetary activities

The Budget Code establishes the legal framework for budgetary activities. It mandates the publication of the approved budget, as well as of the budget execution report, and requires reporting to parliaments at all levels of government. It further stipulates that the draft budget must be accompanied by an extensive array of documents.²⁶ The presentation of extra-budgetary funds to the legislatures for each level of government must coincide with that of the annual budget law. Reports on implementation have to be submitted to the Federal Assembly. However, information on government assets is incomplete. There is no legal requirement for the publication of the financial information of state-owned unitary enterprises or other companies with government stakes, although some information can be obtained from the government's privatisation programmes as well as the website of the Federal Agency for the Management of Federal Property (*Federal'noe agentstvo po upravleniiu federal'nykh imushchestvom*).²⁷

Legal framework for taxation

Russia has a comprehensive Tax Code consisting of two separate parts. Part I, passed in 1998, lays out the basic structure and principles of the tax system. It offers the basic definitions, administrative provisions, and the rights and responsibilities of taxpayers and tax authorities. The law reduces the use of discretion on the part of tax administrators and introduces a basic provision to resolve ambiguities in favour of taxpayers. Part II of the Code was adopted in 2000 with several subsequent amendments. It contains the provisions on individual taxes. The system has been streamlined by eliminating most exemptions.²⁸ A new Customs Code was adopted in 2003 and broadly complies with WTO principles. One of its key objectives was to reduce the scope for discretion in customs proceedings, among other things by standardising documentation requirements.²⁹

The primary responsibility for tax administration lies with the Federal Tax Service under the auspices of the MoF.³⁰ The Federal Customs Service operates under the auspices of the Ministry of Economic Development and Trade.³¹

Since 2001, Russia has been pursuing a gradual reform to simplify the system of taxation, diminish double taxation, and to reduce the overall tax burden.³² One target of the reform is to shift the tax towards raw materials extraction and to reduce the rates on labour and profits.³³ Main measures so far have included the introduction of a flat income

tax, the lowering of the corporate tax jointly with the abolition of exemptions and holidays, a simplification of the VAT regime, and a reduction in the social tax.³⁴

Discrepancies between tax regulations and practices remain, although they are diminishing in number. They are more common at the regional level where tax pledges by companies to fund particular public goods are at times exchanged for tax exemptions, bankruptcy protection, and other privileges.³⁵

Tax enforcement remains another great problem area. Some unofficial estimates now suggest that the share of the unrecorded “shadow” economy might exceed 50% of GDP. The expectations that a significant proportion of it would register as a result of the tax reform are yet to be borne out.³⁶ One of the important side effects of the Yukos affair has been to significantly improve tax compliance, especially by large companies. Among other things, the use of various tax evasion and optimisation schemes has significantly declined. However, some concern is caused by the apparently selective levying of back tax claims on companies, especially in the oil and gas sector.³⁷ Although the damage from the Yukos affair has been effectively contained, it has left perceptions of arbitrariness in the treatment of companies. There have been several instances of companies negotiating down large back-tax claims and in some cases tax compliance seems to depend on concerns over arbitrariness rather than the improved administrative capacity of the tax authorities.

Ethical standards for public servants

The 1995 law “On the Principles of Civil Service” constitutes the basic code governing the behaviour of public officials. A plan to improve ethical standards of behaviour for public servants was set out in a presidential decree entitled “On Approval of General Principles of Official Conduct for Public Officials in the Russian Federation,” adopted in August 2002. A draft “Code of Conduct for Public Officials” passed the first reading in the *Duma* in May 2002 but the second reading has been repeatedly rescheduled since then.³⁸

As genuine as the government’s commitment to administrative reform appears, corruption remains deep-seated in Russia and little concrete progress appears to have been made in curbing it. Indeed, recent indications suggest that the situation is in fact getting worse, at least in terms of the amount of money spent on bribes. For example, a recent report by the INDEM Foundation discovered that the value of corruption in Moscow had increased 10-fold since 2002.³⁹ By all accounts, the line between “information procedures” and outright corruption has effectively vanished and facilitating payments are routinely offered to accelerate procedures. Many officials receive very modest salaries and the monitoring of their behaviour is typically far from adequate.

Studies conducted on corruption perceptions in Russia point to serious problems, but also to considerable inter-regional variations. While the existing laws should be adequate to tackle the problem of corruption, their implementation is often half-hearted and unsystematic. An attempt to address the problem through the government’s Anti-Corruption Council, which was set up in 2003, has to date proven ineffective.

Elements of the administrative reform were deemed to be ill conceived, which has led to some future measures being postponed. In addition, the transition from the old system to the new has resulted in some confusion and disputes over responsibilities between various government entities. A proposed law on access to information, a key element in increasing accountability, is still not in place. Steady progress in this area is expected, although the concrete impact of some initiatives is in considerable doubt. For example, the new Public Chamber (*Obshchestvennaya palata*), which is eventually supposed to have 200 members appointed directly or indirectly by the president of the Federation, has not to date shown much evidence of seriously tackling problems. In spite of its broad remit, many fear that it will be an ineffective discussion forum for celebrities. Nor is it clear that the people appointed will have the necessary skills to address all the relevant concerns. In spite of such delays, however, the commitment to administrative reform remains strong and progress seems unavoidable in the face of the demographic pressures and inter-regional diversity faced by Russia.

The police are widely perceived as the most corrupt professional group in the country and the courts lack the necessary resources to effectively manage their workload. However, efforts to reform the judiciary has made some headway, even if they still remain beholden to the executive in many localities. While judges themselves now receive competitive salaries, the court buildings and staff are typically controlled by the local executive. With the exception of the salaries of judges, the judiciary is still not a separate line in the federal budget. The Transparency International Corruption Perceptions Index in 2005 ranked Russia 126th of the 159 countries surveyed with a score of 2.4 out of 10.0.⁴⁰ Many observers have expressed concern over the negative implications of the centralisation of power, in as much as restrictions of civil society may foster an atmosphere of arbitrariness.⁴¹

2. PUBLIC AVAILABILITY OF INFORMATION



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The public should be provided with full information on the past, current, and projected fiscal activity of government.

Central government operations

The website of the Ministry of Finance now presents comprehensive information on the fiscal activities of the government. Following Russia's SDDS subscription on 31 January 2005, the data is presented in full compliance with IMF standards.⁴² The classification is primarily administrative. The budgets of the federal extra-budgetary funds are published, but the information does not fully conform to the GFS classification. The budget does not include entrepreneurial activities of budgetary organisations. Similarly, the published data on the activities of entities protected by the law "On State Secrets" -- defence, law enforcement, and national security -- is only in aggregate form.⁴³

The disclosure of contingent liabilities, tax expenditures and quasi-fiscal activities still requires significant improvement, although the budget documents now list outstanding guarantees. Similarly, some assessment is typically provided of tax expenditures that will change during the budget year. Although many subsidies, for example to the regions, are identified in the budget documents, there is no systematic assessment due to the non-economic classification of expenditures. There is no assessment of price subsidies in the energy sector. The Budget Code states that public guarantees have an upper limit and constitute a debt obligation as part of the sovereign internal debt of the Russian Federation.⁴⁴ They are thus fully recorded. The Russian government has been generally reluctant to issue guarantees on a large scale.

The federal budget documents since 2002 provide estimates of the budget outturn for the year preceding the budget and summary forecasts for two years following the budget year. The budget estimates are based on two main macroeconomic scenarios prepared by the Ministry of Economic Development and Trade and presented also as part of the government's Social and Economic Programme. The scenarios are based on different assumptions about hydrocarbons prices and global economic growth. The budget is typically based on the more conservative scenario.⁴⁵

Public sector operations

Under the provisions of the Budget Code, all non-confidential information about approved budgets and their execution has to be made public. Thus all budget preparation documents are released to the public upon approval by the government.

In accordance with the Budget Code, the consolidated budget, consisting of the federal and sub-national budgets, is presented to the *Duma*. Quarterly and annual reports on extra-budgetary funds are prepared separately to the main budget. At the federal level, all earmarked funds fall under the Treasury's control. The federal budget documents also provide indicative data on the estimate and outcomes for the general government, with the exception of territorial medical funds.⁴⁶

Regional governments have to compile fiscal reports on all the budgets within their jurisdictions on a monthly and quarterly basis, although the monthly data is not always complete due to reporting lags, in which case budget

estimates tend to be used as a proxy. The quarterly reports cover accounts payable and receivable. *Ex post* data on the implementation of the general government budget -- covering the federal and sub-national governments -- is presented on the MoF website on a monthly basis. The coverage improved last year due to efforts to close down some federal and regional extra-budgetary funds, for example the regional road fund. The lag before publication typically does not exceed one month.⁴⁷ A formal assessment of the consolidated budget of the general government, including the extra-budgetary funds, is published on an annual basis. The budget execution data is compiled in accordance with national concepts and definitions. Although they do not fully match the GFS1986 format, they can be reclassified in accordance with GFS1986.⁴⁸

The Federal Service for Statistics compiles and releases quarterly aggregate data on non-financial public enterprises. The data is available under the category of the “State Sector in the Economy” which covers public enterprises and the entrepreneurial activities of budgetary organisations. The published data covers production, financial results, and employment in state enterprises broken down by sector.⁴⁹

A commitment should be made to the timely publication of fiscal information.

Debt reporting

The MoF collates and discloses public debt data, as well as producing regular reports on the debt guarantees of the federal government. The central bank publishes monthly reports on public sector debt held by non-residents. The MoF conducts an annual inventory of Russian public debt and reconciles discrepancies.⁵⁰

Central government debt data presented by the government are classified by original maturity. Short-term debt is presented separately. Accumulated debt, including interest costs on discounted securities without coupons, is termed at par value. Financial instruments are broken down as securities, loans and deposits. The MoF Domestic Debt page further provides information on planned auctions at least one month in advance.⁵¹

The debt owed by foreign governments to the Russian Federation is appended, as of 2004, to the federal budget documents. Otherwise, there is no systematic publication of government assets.⁵²

Advance release calendars

In compliance with Russia’s SDDS membership, both the central bank and the MoF produce advance release calendars for debt information and for central and general government operations. The data is almost invariably released in timely fashion.⁵³

3. OPEN BUDGET PREPARATION, EXECUTION, AND REPORTING



Enacted

Fiscal policy objectives, macroeconomic framework and risks

Fiscal policy objectives

The preparatory work on the federal budget is now supervised by a Budget Commission involving the prime minister and the ministers of finance and of the economy. The government discloses its fiscal policy objectives in the Annual Budget Law. Budget appropriations follow departmental and functional classifications. In some instances, programme and economic classifications are combined in an inconsistent manner. The budget documents identify most key programmes for each budgetary organisation.⁵⁴ Regional and local governments are required to complete lists of spending commitments.

In addition to the budget law, various medium- to long-term programmes on economic and social development of the country address fiscal plans. The most important of these is the three-year prognosis on the socio-economic situation of the country.⁵⁵ A new government order has now built on this by introducing the requirement -- first applied to the 2006 budget -- to present a three-year medium-term fiscal plan in the budget bill. The 2003 Budget Law was the first to explicitly specify priority areas for public expenditure, even if the relationship between the targets and actual budgetary allocations has tended to be somewhat tenuous.⁵⁶ A government decree of 28 July 2004 -- "General Directions for the Activity of the Government of the Russian Federation for the Period until 2008" sets general targets for policy and suggest greater government activism and several large-scale state investment projects. Major structural reform initiatives are currently being pursued in the budgetary sphere, intergovernmental relations, administrative reform, banking sector reform, social policy, and the restructuring of the electricity sector. The government is eager to substantially boost investment in transportation infrastructure.⁵⁷

Macroeconomic framework

The budget documents present all key macroeconomic assumptions, as well as two basic scenarios for the development of the economy. The forecasts prepared by the MoF Macroeconomic Department draw on macroeconomic models prepared by the Ministry of Economic Development and Trade, the Ministry of Finance, and the central bank with outside consultation involving the IMF and various research institutions.⁵⁸ However, the economic models used are not published. Additional forecasting is carried out by the Ministry of Economic Development and Trade, which prepares the longer-term scenarios of socio-economic development.⁵⁹ The vast majority of the macroeconomic data is not yet incorporated in the published budget documents, although elements of it are published as background material for the government's meetings.⁶⁰

Fiscal risks

There are no formal assessments of fiscal risks in the budgetary documents. However, the government attaches a catalogue of outstanding state guarantees. The annual budget law now places a ceiling on new guarantees and makes a formal provision for guarantees that might be called. Under the Budget Code, the budget may have two reserve funds: a general reserve capped at 3% of total spending and a presidential reserve, which cannot exceed 1%. The general reserve is available for covering unexpected fiscal emergencies -- typically caused by disasters -- and the

presidential reserve is available for unforeseen expenditures authorised by the president, but cannot be used for political purposes.⁶¹

The MoF prepares fiscal risk scenarios jointly with the draft budget. Some observers have expressed concern about the lack of clarity of the methodology used to calculate fiscal risks. The MoF currently formulates even its base scenario on very conservative assumptions, partly in order to control spending by the parliament.⁶²

The main fiscal risk facing Russia comes from the country's high economic dependency on the hydrocarbons sector that, from the fiscal perspective, has continued to grow until recently. In 2003, 40% of federal government revenues came from the oil and gas sector. Since then, the process of shifting the tax burden from individuals to the natural resource sector has continued further with the reduction of the standard (top) rate of the unified social tax last year and an increase in the taxation of hydrocarbons. At Urals oil prices of more than 25 US dollars a barrel, the marginal tax rate including the oil export tariffs and the oil extraction tax has increased 86%. While the Stabilisation Fund will help manage sudden reversals, the fiscal implication of a substantial drop in oil prices have become considerable. At more than 25 dollars a barrel, a one-dollar decline in oil prices is estimated to reduce general government revenues by approximately 0.41%.⁶³

Potentially significant contingencies result from irresponsible, and imperfectly monitored, behaviour by regional governments. There are some suspicions that the federal authorities would be willing to bail out regions and significant companies in financial difficulty in order to protect Russia's credit rating. However, increased federal control over the regions is likely to reduce the probability of this outcome.

Fiscal sustainability

The budget documents do not have an explicit formalised discussion of sustainability, although some aspects of it are addressed in broad terms. However, the Budget Code sets out rules concerning the government deficit with a view to ensuring sustainability: the federal budget deficit must remain below total budgetary investment including interest expenditures; current expenditure cannot rise above current revenue for all levels of government. Regions must ensure that their deficit stays below 5% of their revenues (excluding federal grants) and cannot exceed their investment expenditure.⁶⁴

Russia has in recent years established a high degree of fiscal stability and this looks set to continue, although the encouraging results still have much to do with the strength of the oil and gas sector. The previously significant problems of public sector and foreign indebtedness have been brought under control in recent years. Stress tests suggest that the situation will remain manageable in the absence of severe shock, even though the declining trend of recent years is set to give way to relatively stability and possibly even a gradual increase in the coming years.⁶⁵ Even as the high oil revenues will serve as a guarantee of fiscal sustainability for as long as they last, the windfall is also generating growing pressures for social spending and a generally looser fiscal stance.

The hydrocarbons sector should offer Russia reasonable prospects of ensuring fiscal sustainability for the longer term, as well. Under current output levels, Russia's oil reserves are projected to last for another 20 years and gas reserves for 80 years.⁶⁶ Many analysts suspect that these figures are underestimates and parts of the country, especially in eastern Siberia, have not been subjected to proper assessments yet. The Stabilisation Fund now constitutes an important element of the government's sustainability strategy. It was established in the 2004 budget as a repository for oil revenues when the price exceeds 20 US dollars a barrel. After this point, only one-half of the revenues will be deposited in the fund, with the rest to be used to repay debt and to cover the deficit of the Pension Fund.⁶⁷ The assets of the Fund will likely be invested in liquid foreign currency-denominated securities that have been rated AAA by at least two rating agencies, although the low levels of interest rate may create pressure for the strategy to be revised.

The main challenge comes from the mounting pressures to use the funds in the Stabilisation Fund right away for politically inspired purposes. Although the government remains committed to protecting the integrity of the fund, the high oil prices were used as the justification for increasing the threshold level for triggering contributions of the Fund from 20 dollars to 27 dollars a barrel in the 2006 budget. The differential will instead be deposited in a new Investment Fund, which will be used to finance infrastructure projects. The size of the Investment Fund is expected to be approximately 70 billion roubles in 2006.

The main longer-term threat comes from the unfavourable demographic situation with an ageing population and a low retirement age. The government is currently reforming the pension system starting with the introduction in 2002 of a funded scheme in addition to the old pay-as-you-go system. However, the notional defined contribution scheme continues to have serious shortcomings and the reform has been watered down to a degree. Even the reformed system is characterised by a high degree of state involvement due to the small second-pillar contributions, which are only 4-6% of wages. In addition, the leading manager of the funded contributions (some 90% of them) is the state-owned Vneshekonombank, which, moreover, invests virtually all its receipts into government bonds. In contrast, the 55 or so private asset management companies, whose annual investment plans are approved by the Federal Financial Markets Service, typically invest quite heavily in equities. While the planned reform is fiscally sustainable on most scenarios, its solvency depends on steadily declining replacement ratios, which may turn out to be politically unacceptable.⁶⁸

Budget presentation

Data reporting

The annual law “On the Federal Budget” follows a functional classification of expenditure and revenue items on which parliamentary decisions need to be taken. A comparable system is used at the sub-national level.⁶⁹ The budget bill is now presented with most of its appendices before the *Duma* readings begin, a marked improvement on 2004 when only a small number of appendices were included at first. This is an important element of the May 2004 project of reforming the budgetary process.

The Federal Budget Code details the system of data classification used in budget documents at all levels of government.⁷⁰ In spite of steady improvement, expenditure classification still excludes economic categories and combines administrative and functional categories. The situation is likely to improve as a result of the ongoing transition to a system of explicit performance budgeting. In connection with the preparation of the 2004 budget, state bodies were asked by the MoF to submit the objectives of their programmes. This plan largely collapsed due to an ineffective response on the part of the line ministries as well as limitations in their administrative capacity. However, the government is working on reforming it on the basis of the experiences to date. A formal plan of measures on implementing the budget reform programme covers the years 2004-6 and is available on the MoF website.⁷¹

The budget has cost estimates for all major initiatives and special programmes as compared to the ongoing fiscal commitments of the government. There is a specific discussion of both the fiscal and the economic implications of tax reforms. However, no detailed analysis of the sensitivity of the government’s estimates to changes in macroeconomic conditions is provided.⁷²

Budget execution and monitoring

The ex ante control of public sector expenditures has improved dramatically as a result of the reform of the Federal Treasury, which has an extensive network of local offices. The Treasury is now responsible for the financial flows

of all federal budgetary organisations and maintains a webpage where budget data at the central and general government levels is presented with a lag of six weeks.⁷³ Budgetary organisations are required to pre-register some commitments with the Treasury, especially with respect to utility payments. All payment orders are registered with Treasury offices where they are checked against warrants before execution. The Treasury is currently working on establishing a single-account system based at the CBR in Moscow and the local bank accounts of all spending units have now been closed, with all flows taking place through the regional CBR offices.⁷⁴

The situation at the regional level continues to be quite mixed. In most regions, especially ones receiving substantial federal subsidies, the Federal Treasury executes budgets, whereas some advanced regions such as St Petersburg have set up their own treasuries.⁷⁵ The MoF now publishes monthly and quarterly data on the execution of the budget on its website. Monthly data is available on each regional government.⁷⁶

In spite of a generally positive trend, the relationship between budgetary allocations and actual spending remains far from perfect. However, this does not appear to be primarily due to the Treasury system, which is relatively strong. Rather, shortcomings in budget management at the ministerial level and in connection with specific policies bear most of the blame.⁷⁷ The gradual transition to performance budgeting should improve the situation.

There is no legal requirement for a mid-year budget review by the Federal Assembly, although there is quarterly reporting and the government can submit budget amendment bills during the year. In addition, the government can, under particular circumstances and subject to fairly strict limitations, amend the budget without parliamentary approval. This is typically limited to moving funds between institutions and programmes but not between functions. Special powers apply in emergency situations or in connection with the restructuring of government institutions. However, any increase in the overall expenditure level or the budget deficit requires approval by the *Duma*.⁷⁸

Internal control and audit procedures have improved considerably in recent years but are still deemed to fall short of international standards. The main internal auditor is the newly constituted Federal Service for Financial-Budgetary Surveillance (*Federal'naia sluzhba finansovo-biudzhethnogo nadzora*), which operates under the auspices of the Ministry of Finance. The Federal Treasury controls payments directly. Special commitment controls are applied to utility payments and they have been successfully used to avoid arrears. While expenditure arrears appear to have been largely eliminated at the federal level, they remain a problem in some regions. Most internal audit still focuses on procedural control.⁷⁹

Accounting basis

Most fiscal flows in Russia are reported on a cash basis. The MoF is currently holding discussions concerning the unified methodology for accounting principles, although many difficulties remain.⁸⁰ Russia has signalled that it intends to move towards a system of data reporting on an accrual basis, gradually replacing the cash based system. The MoF is currently working on a Budgetary Chart of Accounts on an accrual basis. The Chart would be integrated with the budget classification and would further incorporate the provisions of GFS2001.⁸¹

Procurement and employment

The Budget Code, the 1997 presidential decree “On Public Procurement Tenders”, and the 1999 Law on Public Procurement provide the main procurement regulations. Local level public procurement is done on the basis of the Law on Local Public Services. All tenders are announced publicly at least 45 days prior to the deadline in “Competitive Tenders”, the weekly newspaper of the Federal Centre of Project Finance (*Federal'nyi tsentr proektnogo finansirovaniia*). However, most of them have predetermined results shaped by personal connections. Foreign bidders are often shut out by the legal provision to consider them only if a good or service is not available from domestic producers or cannot be produced economically by Russian companies.⁸²

In spite of the formal codification of the process, the adoption of open and transparent procurement procedures has moved slowly. According to the Ministry of Economic Development and Trade, there were only 10,000 open tenders during the first half of 2003. This compares to 142,000 closed tenders or single-quote purchases.⁸³

The Ministry of Finance and the Ministry of Economic Development and Trade have adopted a programme for monitoring procurement at the federal and regional levels. However, control is imperfect and largely procedural. All tenders are potentially subject to investigation by a *Duma* committee but this option is seldom exercised and naturally insufficient for comprehensive control.⁸⁴

The Labour Code is the main law governing employment-related issues.⁸⁵ A 1996 presidential decree on searches for civil service vacancies stipulates an open and competitive application and appointment process. However, hiring decisions are often far from transparent and the official search a mere formality.⁸⁶

Fiscal reporting

The Treasury provides summary reports on the budget execution to the *Duma* on a monthly basis and within one month of the reference month. The MoF also publishes quarterly reports on budget execution with relevant commentaries. Audited annual reports are provided within 13 months of the year-end. Final accounts of the consolidated government are also provided.⁸⁷

The availability of information on the activities of the Ministry of Defence has improved in recent years but much of it is still presented in an aggregate form on national security grounds. The Ministry still owns approximately 400 unitary enterprises, although their numbers have been falling.⁸⁸

4. ACCOUNTABILITY AND ASSURANCES OF INTEGRITY



Enacted

Data quality standards

The quality of fiscal data disseminated by the authorities has increased dramatically in recent years. Russia's SDDS subscription in January 2005 constitutes an important recognition of this, as well as formalising the commitment to international best practice. Most observers deem Russian fiscal data to be comprehensive and quite accurate, even if budget projections have tended to a bias towards caution. Information on fiscal activities is disseminated in a timely fashion. In many areas, methodological discrepancies between Russian organisations, and deviations from international standards, create problems from the viewpoint of consistency and reliability. A particular problem exists with expenditure data classified by type, which is published with a long delay of up to one year.⁸⁹ The government fiscal data is based on Treasury records, which are reconciled with spending units. As a rule, information on the methodological aspects of data collection is not available. The Treasury is currently working on consolidating the accounting practices of the Treasury and the various budgetary organisations. A Treasury general ledger system will be introduced in the coming years.⁹⁰

Independent scrutiny of fiscal information

Independent Audit

The principal body responsible for auditing government activities in Russia is the Accounts Chamber of the Russian Federation (ACRF). The federal law No 4-FZ of 11 January 1995 "On the Accounts Chamber" grants the body institutional independence. The second chamber of the *Duma* evenly shares the appointments of the director, his deputies, and the current 11 auditors; all appointments are made for a six-year term. In practice, the statutory independence has been eroded somewhat by the federal law No 145-FZ of 1 December 2004 "On Introducing Changes to the Federal Law 'On the Accounts Chamber'." Under its provisions, the chairman and deputy chairman of the ACRF are nominated by the president of the Russian Federation.⁹¹

The ACRF assesses the state budget, including the macroeconomic assumptions, before it is passed by the *Duma*. The ACRF is legally responsible for controlling the timely execution of the federal budget and for evaluating the validity of income and expenditure categories in it.⁹² It can investigate any discrepancies in the budget and recommend measures for their elimination, and can do the same with extra-budgetary funds. The ACRF is further responsible for auditing the use of state property (including privatisations). The Chamber has unfettered access to Treasury data and is legally required to report to the parliament on the execution of the federal budget on a quarterly basis. The Chamber can conduct special ad hoc investigations on particular areas of the budget and particular activities of the extra-budgetary funds. Such operations are carried out in conformity with annual and longer-term plans. Additional investigations can be requested by a minimum of one-fifth of the deputies of either chamber of the federal parliament.⁹³ Some observers have voiced concern over ways in which various ad hoc activities and responsibilities to provide analysis and recommendations can compromise the ACRF's ability to carry out its core functions.⁹⁴ Limited resources in general make a systematic audit of all aspects of federal finances impossible, and in-depth analysis is possible only on a very selective basis. The ACRF is beginning to introduce performance audits on a fairly systematic basis. All ACRF audit reports, with the exception of those affected by the legislation on state secrets, are published and available on the website.

The audit of sub-national governments in Russia remains more problematic. The ACRF is authorised to review the books of regional and local authorities, as well as other entities, only in as much as they use federal funds.⁹⁵ This provision is typically applied only to so-called targeted funds that are specially earmarked for particular projects. However, most federal funds are untargeted. Regional auditing chambers that are created by, and accountable to, regional parliaments audit the accounts of regional governments. Municipalities typically set up committees for external audit. However, there is no unified nationwide standard on the sub-national level and the quality and scope of audits varies a great deal. The provision to employ external auditing firms is seldom exercised.⁹⁶ All organisations with a minimal state stake of 25% are subject to a compulsory annual audit, and a 2002 decree governs the procedure for appointing the auditors for such audits.⁹⁷

National Statistics Agency

The main administrative authority responsible for the compilation and dissemination of statistical data in Russia is the newly constituted Federal Service for State Statistics (*Federal'naia sluzhba gosudarstvennoi statistiki* -- FSGS), which operates on the basis of the July 2004 government resolution on the Federal Service for State Statistics.⁹⁸ In addition to its central operations in Moscow, FSGS has offices in all of Russia's regions and districts. FSGS enjoys organisational independence as an organ of executive power but no legally enshrined independent status. An independent scientific and methodological board supervises the quality of FSGS activities. Russia subscribed to the Special Data Dissemination Standard of the International Monetary Fund on 31 January 2005, which marks a high degree of convergence between the national statistical system and international best practice standards.⁹⁹

The MoF, in accordance with a joint agreement, compiles the fiscal data disseminated by FSGS. FSGS is not able to conduct checks to verify the quality of fiscal data once an agreement has been concluded. The Government Finance Statistics unit of the Ministry of Finance, which was created in 1999, compiles most fiscal data. The unit publishes a yearbook, albeit with a considerable lag. Considerable methodological problems remain with expenditure data.¹⁰⁰ While the quality of fiscal data is generally good, there are evident incentives at the local level to misrepresent things. As of now, there is no effective performance accounting in the financial sphere.

FSGS is working with the government to improve standards but its work is frequently constrained by limited budgetary resources, especially at the regional and local level. Low compensation has created problems in ensuring adequate staffing levels and vacancies are common. The shortages are particularly acute in the area of national accounts. There is close collaboration with Eurostat in several areas.¹⁰¹

INTERVIEWS

Representatives of *Oxford Analytica* interviewed the following individuals during a visit to Russia between 10 and 14 October 2005:

Ministry of Finance

12 October 2005

Aleksandr A. Komkov	Consultant	Department of Macroeconomic Policy
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Central Bank of the Russian Federation

11 October 2005

Ekaterina Prokunina	Deputy Director	General Economic Department
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ADDITIONAL INTERVIEWS

10 October 2005

Neven Mates	Senior Resident Representative	International Monetary Fund
Vadim Kleiner	Director of Research	Hermitage Capital Management

11 October 2005

Elena Panfilova	Director	Transparency International-R
Aleksei Makrushin	Economist	CEFIR
Vladimir V. Klimanov	Director	Institute for Public Finance Reform (<i>Institut Reformirovaniya Obshchestvennykh Finansov</i>)

12 October 2005

Richard Hainsworth	Director	RusRating
Galina Kurlyandskaya	General Director	Center for Fiscal Policy (<i>Tsentr fiskalnoi politiki</i>)
John Litwack	Chief Economist	World Bank, Moscow
Al Breach	Research Director	Brunswick UBS

13 October 2005

Anton Strouchenevski	Economist	Troika Dialog
Vladimir I. Tikhomirov	Senior Economist	Uralsib
Alexey Moisseev	Deputy Head of Research	Renaissance Capital

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